

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS
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In the Matter of)

)

Price Cap Performance Review)
for Local Exchange Carriers)

CC Docket No. 94-1

COMMENTS OF AMERITECH IN RESPONSE TO FOURTH FURTHER
NOTICE OF PROPOSED RULEMAKING

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Ameritech¹ submits these comments in response to the Commission's Fourth Further Notice of Proposed Rulemaking in this proceeding.² In the Fourth FNPRM, the Commission focuses particularly on elements of the local exchange carrier ("LEC") price cap formula itself -- especially productivity measurements, sharing, the common line formula and exogenous costs.

I. INTRODUCTION

The total factor productivity ("TFP") methodology, as revised and simplified by Christensen, is consistent with the Commission's objectives for a productivity factor in the long-term price cap plan for LECs. Ameritech would also suggest that the Commission give serious consideration to the elimination of the X-Factor and to instead directly calculate a PCI adjustment

¹ Ameritech means: Illinois Bell Telephone Company, Indiana Bell Telephone Company, Incorporated, Michigan Bell Telephone Company, The Ohio Bell Telephone Company, and Wisconsin Bell, Inc.

² In the Matter of Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, Fourth Further Notice of Proposed Rulemaking, FCC 95-406 (released September 27, 1995) ("Fourth FNPRM").

based on the difference between the percentage change of LEC input prices and LEC TFP. This direct method accounts for LEC input price changes and would simplify the calculation of the PCI adjustment factor.

Any productivity-related factor should be based on an industry-wide average to provide additional productivity incentives.

With the adoption of the proposed Christensen TFP methodology as the basis for either the X-Factor or the direct method, no separate common line formula would be necessary.

In addition, with the implementation of a long-term price cap plan that includes a productivity factor that meets the Commission's criteria, the consumer productivity dividend should be eliminated.

Further, since the use of the TFP methodology with a rolling average removes any uncertainty that LEC productivity is appropriately reflected in the PCI, the sharing backstop mechanism should be eliminated.

Also, a lower LEC productivity component should be available for those LECs that have eliminated barriers to competitive entry. In addition to encouraging pro-competitive LEC behavior, such an option would acknowledge the fact that, in cases of competition, LEC productivity may actually decline.

Finally, the Commission should not set any particular time for the next performance review.

II. AMERITECH SUPPORTS THE USE OF TOTAL FACTOR PRODUCTIVITY AS CALCULATED BY CHRISTENSEN FOR THE BASIS OF ANY PCI ADJUSTMENT FACTOR.

The Commission has indicated that the productivity factor, the X-Factor, that will be implemented in the long-term price cap plan for LECs should have three essential characteristics: it should be economically meaningful; it should ensure that productivity gains are passed through to ratepayers; and it should be reasonably simple and based on accessible and verifiable data.³

Ameritech supports the adoption of the TFP methodology, as revised and simplified by Christensen in connection with USTA's comments submitted this date. Adoption of this TFP methodology would do much to satisfy the Commission's goals for a long-term price cap plan. The updated study is based on the same theory, and employs essentially the same computations, as the previous Christensen study filed earlier in CC Docket No. 94-1.⁴ As noted by Christensen, the proposed simplifications do not deviate from "best practices." The revisions to the Christensen study, as detailed in USTA's filing, respond to the concerns raised by the Commission and various intervenors and simplify the TFP calculation. Consistent with the Commission's objectives, the Christensen study is soundly based on economic theory, (with the proposed five-year rolling average) results in

³ Id. at ¶16.

⁴ Filed with USTA's Comments, May 9, 1994.

productivity gains being flowed through to access customers, employs calculations that are reasonably simple, and uses public and verifiable data.

While Ameritech supports the TFP methodology, it also believes that the Commission should give serious consideration to the elimination of the X-Factor entirely and instead directly calculate a PCI adjustment based on the difference between the percentage change of LEC input prices and LEC TFP. Currently the FCC formula is $\text{PCI Adjustment Factor} = \text{GDP-PI} - \text{X-Factor} + / - Z$.⁵ Ameritech would consider a formula where the $\text{PCI Adjustment Factor} = \% \Delta W_{\text{LEC}} - \% \Delta \text{TFP}_{\text{LEC}} + / - Z$ as an alternative to setting an X-Factor.⁶ The simplified Christensen study, as filed in this instant proceeding by USTA, also serves as the source for the data needed to derive this modified formula.

The Commission solicits comment on how to account for changes in LECs' input price for use in a TFP approach to calculating the X-Factor. The Commission also has suggested that a statistically significant input price differential exists and can be calculated.⁷ Appendix F of the First Report and Order concludes that the input price differential for the 1984 - 1990 time

⁵ Where $\text{X-Factor} = (\% \Delta \text{TFP}_{\text{LEC}} - \% \Delta \text{TFP}_{\text{US}})$; Z = exogenous cost changes, and GDPPI = Gross Domestic Product Price Index.

⁶ $\% \Delta W_{\text{LEC}}$ = % change in LEC input prices. $\% \Delta \text{TFP}_{\text{LEC}}$ = % change in LEC TFP. Preliminarily, Ameritech suggests that it is most appropriate to calculate both components $\% \Delta W_{\text{LEC}}$ and $\% \Delta \text{TFP}_{\text{LEC}}$ on a rolling average basis using at least 5 years of data for the average. In any event, the volatility associated with the input price component needs to be smoothed.

⁷ In the Matter of Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, First Report and Order, FCC 95-132 (released April 7, 1995) ("First Report and Order") at Appendix F.

period should be included in calculating the X-Factor.⁸ Over the long run, the input price differential is zero. The study by NERA included with USTA's comments demonstrates that there is no evidence that the long-term input price growth rates for the LEC industry and the U.S. industry in general are different, and that no difference should be embodied in a value of X intended to represent a long-term industry average productivity target. In addition to NERA, both Christensen⁹ and Duncan¹⁰ have presented evidence that indeed the input price differential is zero.

As indicated above, Ameritech would consider the direct method (growth of LEC input prices minus the rate of LEC TFP growth) to account for LEC input price changes. Application of the direct method would simplify the calculation of the PCI Adjustment Factor since it would eliminate economy wide data on inflation and productivity from the price cap formula. Additionally, this method addresses the Commission's concern about how to account for LECs' input price and eliminates the need to deal with the input inflation differential. This is the formula used by the Interstate Commerce Commission for regulating the railroads -- changes in railroads' costs reflect

⁸ The validity of the Commission's calculations has been reviewed by NERA, the results of which are submitted with USTA's comments filed this date.

⁹ See, ex parte Affidavit of Dr. Laurits R. Christensen on behalf of the United States Telephone Association, CC Docket No. 94-1, dated February 1, 1995.

¹⁰ See, GTE California, Incorporated, Direct Testimony of Dr. Gregory M. Duncan, California Public Utilities Commission NF Reform Proceeding - I.95-05-047, dated September 1995, at pages 5-10.

changes in railroad productivity as well as changes in railroad input prices.¹¹ The Commission's review of the LEC input price series in Appendix F of the First Report and Order indicates that the Commission is comfortable that a reliable LEC input price series is available. In fact, the Commission relied on LEC input price data filed by Christensen¹² which will again be available using the simplified Christensen study. If this method were to be adopted, the input price component would need to be smoothed through the use of a moving average or possibly an autoregression methodology, due to its volatile nature.¹³

Ameritech supports the simplified Christensen TFP methodology as submitted with USTA's comments as the method which best meets the Commission's criteria for capturing LEC productivity. Ameritech opposes other methods set forth in the Fourth NPRM for calculating the X-Factor. They do not meet the criteria which the Commission established for capturing LEC productivity. For example, the Historical Price Method does not measure productivity but rather infers changes in productivity from changes in prices. The Historical Revenue Method is flawed since it relies on arbitrary regulatory accounting. Moreover, it dampens the incentives that

¹¹See Interstate Commerce Commission Ex Parte No. 290 (Sub-No. 7) Productivity Adjustment-Implementation, decided October 26, 1993, 9 I.C.C. 2d 1072.

¹²Appendix F, as included with the First Report and Order, made use of Christensen data.

¹³Within the direct method, there are a number of ways that the historical data can be used to calculate LEC output growth for a given year. One method is to use a rolling average for a fixed number of years, at least 5 for both the LEC input price inflation and LEC TFP. This method, similar to that proposed by Christensen in the TFP study, would use a fixed lag such as 2 years. The lag should be limited only by the availability of data in order to ensure timely updates.

price cap regulation was designed to produce and is a regression to rate of return regulation.

The Commission may, nonetheless, believe it is appropriate to have an adjustment (e.g., interstate output growth factor) to the baseline PCI Adjustment Factor (based on TFP). Although Ameritech supports the simplified Christensen TFP methodology as the basis for the PCI Adjustment Factor, Ameritech is willing to consider modifications to this position that are economically meaningful. However, Ameritech at this time has found no economically meaningful way to make adjustments to the PCI Adjustment Factor.

III. THE FACTOR SHOULD BE BASED ON AN INDUSTRY-WIDE AVERAGE.

As has been the case previously any factor, be it the PCI Adjustment Factor or X-Factor, should be calculated on an industry-wide basis. The use of an industry-wide factor yields a very powerful benefit; it provides the LEC with a powerful incentive to become more productive than other price cap LECs. LECs will try to beat the industry productivity improvement average. Those companies whose internal productivity exceeds that of the industry will benefit through higher earnings. Those whose internal productivity lags the industry will be encouraged to reduce costs and find ways to increase output growth. Moreover, a rolling average will further ensure that ongoing gains by the LECs in reducing unit costs are passed through to access customers.

IV. THE CONSUMER PRODUCTIVITY DIVIDEND SHOULD BE ELIMINATED.

The inclusion of a Consumer Productivity Dividend ("CPD") would no longer be appropriate in a long-term price cap plan. The CPD was put in place as an arbitrary measure in an attempt to compensate for uncertainty as to the development of an X-Factor fully capturing productivity. Since the Commission should be able to put in place a long-term price cap plan based on economically meaningful, accessible and verifiable data, that uncertainty will be gone. Furthermore, there will be even less reason for a CPD if the FCC decides to use a five-year rolling average of TFP in setting the PCI Adjustment Factor since all productivity gains will be flowed through to customers.

V. NO SEPARATE COMMON LINE PCI FORMULA IS NECESSARY.

The Commission has inquired specifically into the application of price caps to the common line basket.¹⁴ The adoption of a TFP-based PCI Adjustment Factor the direct method suggested by Ameritech eliminates the need for a separate common line PCI. TFP measures all inputs and all outputs. A TFP-based methodology looks at CCL/MOU as an outgrowth measure. Using any further adjustment to the common line basket to reflect productivity gains would result in a double counting. Further, the Commission's proposal to base carrier common line rates on historical, rather

¹⁴ Fourth FNPRM at ¶¶ 130-137.

than forecasted, data for end user common line revenues is consistent with the use of historical data elsewhere in the price cap formula.

VI. SHARING SHOULD BE COMPLETELY ELIMINATED FROM PRICE CAP REGULATION.

The Commission has generally inquired into the role that sharing should play in price cap regulation, especially in the context of the X-Factor.¹⁵

The Commission itself has noted that "The sharing mechanism blunts the efficiency incentives created by the price cap formula."¹⁶ In particular the Commission recognized the need to eliminate sharing to provide greater incentives for productivity increases when in the First Report and Order it created the no sharing option. In fact, Ameritech wholeheartedly supports the elimination of all earnings sharing, which has no place in a properly crafted price cap plan. Earnings sharing simply discourages infrastructure development and the deployment of advanced new services. A LEC which is facing a decision on investing in a new service could definitely be deterred in the first instance by potential earnings constraints.¹⁷

Furthermore, earnings-based regulation has no place in a competitive environment and would create unreasonable administrative barriers to transitioning services out from under price cap regulation to streamlined

¹⁵ Fourth FNPRM at ¶¶ 96-128. See also In the Matter of Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, Second Further Notice of Proposed Rule making, FCC 95-393 (released September 20, 1995) ("Second FNPRM") at ¶¶ 163-172.

¹⁶ Fourth FNPRM at ¶ 114.

¹⁷First Report and Order at ¶ 189.

regulation. For example, with sharing, if services were removed from price caps, a cumbersome and potentially troublesome cost allocation scheme would have to be employed to remove costs of those services, which would no longer be subject to price caps, from the calculation of earnings for sharing purposes.

Finally, if the Commission adopts a rolling average TFP formula, the annual updates to the PCI Adjustment Factor will eliminate any arguable need for a sharing “backstop” mechanism.

VII. THE COMMISSION SHOULD ADOPT A LOWER LEC PRODUCTIVITY COMPONENT FOR LECS WHO HAVE ELIMINATED COMPETITIVE ENTRY BARRIERS.

The Commission seeks comment on whether it should employ multiple X-Factors.¹⁸ Ameritech believes that the Commission should only adopt multiple X-Factors if it promotes and reflects the growth of local exchange and access competition. Specifically, Ameritech supports putting in place a structure that allows for a reduced LEC productivity component where entry barriers to local exchange competition, which have a direct bearing on switched access competition, are eliminated. More particularly, a price cap LEC should be able to take advantage of this reduced LEC productivity component when, in a given region , study areas representing more than half of all access traffic meet the following criteria:

¹⁸ Fourth FNPRM at ¶¶ 108-111; Second FNPRM at ¶¶ 159-162.

- 1) certification of competing local exchange carriers is permitted;
- 2) tariffs for unbundled loops and ports are in effect;
- 3) arrangements for interconnection of competitive local exchange networks with the LEC network, including reciprocal compensation, are available;
- 4) interim number portability arrangements are in place; and
- 5) competitive local exchange providers have fair and equal accesses to numbering resources.

When these conditions are met, PCI adjustments for LEC access services in that region should be calculated on the basis of a reduced LEC productivity component regardless whether the X-Factor or the direct method is employed.

The multiple option approach would recognize those LECs that have taken the initiative to promote both local exchange and interstate access competition and provide an incentive for those LECs that have not moved aggressively in that direction to do so now.

In addition, it is reasonable to adopt this approach because price cap LECs have greater barriers to overcome to meet productivity levels as competition increases. As has been noted by Christensen, firms like the price cap LECs, whose provision of services are characterized by economies of density, are likely to experience a decrease in productivity during the transition to a competitive marketplace.¹⁹ Demand will decline in lower cost/higher margin areas, while the LEC is still burdened with fixed costs. In addition, marketing costs will have to be increased in response to competition -- all this while revenues potentially decline because of increased competitive presence.

¹⁹ See, note 4, supra.

It should be clear, however, where the above conditions are met and at least one competitor is present or where competitive facilities are available to customers representing 25% of all access traffic in an area, relevant services should be removed from price caps entirely and not subject to the PCI Adjustment Factor.²⁰ In those cases, competitive pressures will sufficiently constrain LEC pricing.

VIII. EXOGENOUS TREATMENT OF COSTS WOULD STILL BE APPROPRIATE UNDER CERTAIN CIRCUMSTANCES.

The Commission has solicited comments on whether the adoption of any particular X-Factor calculation would render moot the need to treat any costs as exogenous.²¹ Ameritech submits that it is not possible to construct a PCI Adjustment Factor that anticipates all future exogenous cost changes. To that extent, the Commission should not preclude in advance the possibility that particular costs might appropriately be treated as exogenous under any PCI Adjustment Factor that it adopts in this proceeding. For that same reason, exogenous cost changes should not be limited to only those that result in jurisdictional cost shifts.

²⁰ See Ameritech's Comments filed December 11, 1995, in response to the Second FNPRM.

²¹ Second FNPRM at ¶¶ 138-141.

IX. THE COMMISSION SHOULD NOT, AT THIS TIME, SCHEDULE ANOTHER PERFORMANCE REVIEW.

The Commission has inquired as to whether it should schedule another price cap performance review.²² It is anticipated that the Commission will adopt an appropriate long-term price cap regulatory scheme in this docket. The adoption of a rolling average TFP calculation for the X-Factor should eliminate many concerns about the necessity of a regular periodic review. Therefore, the Commission should not, at this time, schedule any specific time for the re-examination of price cap regulation. Neither, however, should it preclude any such re-examination if circumstances should so require.

X. CONCLUSION.

The TFP methodology, as revised and simplified by Christensen, is consistent with the Commission's objectives for a productivity factor in the long-term price cap plan for LECs. Ameritech would also suggest that the Commission give serious consideration to the elimination of the X-Factor and to instead directly calculate a PCI adjustment based on the difference between the percentage change of LEC input prices and LEC TFP. This direct method accounts for LEC input price changes and would simplify the calculation of the PCI adjustment factor.

²² Id. at ¶¶ 142-143.

Any productivity-related factor should be based on an industry-wide average to provide additional productivity incentives.

With the adoption of the proposed Christensen TFP methodology as the basis for either the X-Factor or the direct method, no separate common line formula would be necessary.

In addition, with the implementation of a long-term price cap plan that includes a productivity factor that meets the Commission's criteria, the consumer productivity dividend should be eliminated.

Further, since the use of the TFP methodology with a rolling average removes any uncertainty that LEC productivity is appropriately reflected in the PCI, the sharing backstop mechanism should be eliminated.

Also, a lower LEC productivity component should be available for those LECs that have eliminated barriers to competitive entry. In addition to encouraging pro-competitive LEC behavior, such an option would acknowledge the fact that, in cases of competition, LEC productivity may actually decline.

Finally, the Commission should not set any particular time for the next performance review.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Michael Pabian", written over a horizontal line.

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